# ADIAN FEDERALISM ECONOMIC UNION

## ership for Prosperity

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# CANADIAN FEDERALISM AND ECONOMIC UNION



## Partnership for Prosperity

Canada

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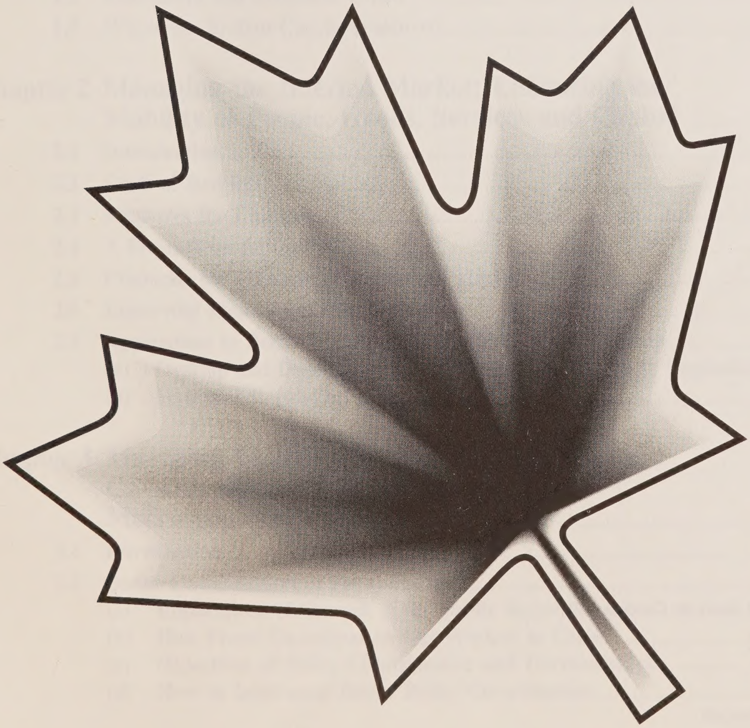

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# Preface

Canada's federal system of government promotes an economic union that has served Canadians very well. In a number of important respects, however, it can be made more efficient and thereby secure and enhance the prosperity of Canadians in the challenging global environment emerging before us.

The proposals advanced in **Shaping Canada's Future Together: Proposals** will be the object of considered discussion among Canadians and by a Special Joint Committee of Parliament over the coming months. That document itself is necessarily brief. The purpose of this companion piece is to set out in greater detail the rationale for these proposals and how they might work in practice, in order to facilitate this process of discussion, debate and decision-making.

In assessing possible reforms, it is first necessary to examine how well economic union has operated — which aspects have worked well, and which aspects need to be improved. The first chapter of this document provides such an examination. By almost any yardstick, economic union has functioned well. For example, Canadians enjoy the second highest standard of living in the world. But standing still should never be the objective. Indeed, our current standard of living cannot be preserved by standing still while the rest of the world continues to evolve.

At the heart of efficient economic union is the free flow of people, goods, services and capital. This requires an absence of internal barriers. As barriers to international flows are coming down around the world, it is necessary now more than ever to address barriers to efficiency in our own domestic market. There are important impediments to the free flow of goods, services, people and capital, which prevent Canada from reaching its full potential. **Shaping Canada's Future Together: Proposals** sets out proposals to improve the functioning of the Canadian internal market.

Poor co-ordination between the fiscal policies of the various governments and inadequate harmonization of fiscal policies with monetary policy constitute another factor that has prevented Canada from delivering its full economic potential to Canadians. **Shaping Canada's Future Together: Proposals** sets out a number of proposals for improving the process of co-ordinating fiscal policies across governments and with monetary policy. It also proposes changes to the mandate of the Bank of Canada and reforms to increase the transparency of its operations and the public understanding of monetary policy. This document elaborates on these proposals in practical terms.

# Chapter 1

# Federalism and Economic Union: Benefits and Scope for Improvement

## 1.1 Introduction

Since the inception of this country, Canadians have greatly benefited from close economic integration. Canada's economic and political union, drawing its strength from a federal structure that respects our diversity while allowing us to live and grow together in a common land, has generated sizeable economic gains for all Canadians. Over the post-war period, Canada has been one of the industrialized world's fastest growing economies. One reason is the flexibility of the Canadian economy in adapting to change: from an economy once based almost exclusively on natural resources, we have built a diversified industrial economy and become a worldwide force in a number of modern industries. As a consequence, Canadians enjoy the second highest per capita incomes in the world, and have created a caring — and sharing — society that offers opportunity to all of its citizens.

The framework of Canadian federalism, while not perfect, has proven flexible and quite effective over the years. Yet today, Canada, like other countries, is facing both external and internal economic challenges. The external challenges of globalization and technological change require improved strategies and greater effort to enhance productivity and opportunities for growth. Greater adaptability and more effective approaches to how federal and provincial governments interact with each other and with the private sector will also be required to keep the Canadian economy internationally competitive.

Internally, the challenges we face in managing our economic interdependence within Canada's federal system are no less urgent. These challenges make it more necessary than ever to address weaknesses, to keep us moving forward so that we may preserve and enhance the welfare of all Canadians. Two particular areas require improvement: achieving greater freedom in the flow of goods, services, capital and people within the economic union, and ensuring greater co-ordination and transparency of economic policies.

It is a sad irony that, in recent decades when considerable progress is being made in removing barriers to the free flow of goods and services internationally, the internal Canadian market still suffers from self-imposed internal barriers. For example, as financial markets around the world are evolving at a tremendous pace, the financial sector in Canada is impeded by overlapping regulation by the various governments. Too often, the fiscal policies of the federal and provincial governments work at cross purposes with each other and with monetary policy. And, too many times, the nature of policy deliberations leaves the public with little understanding of the issues and a sense of not being part of deliberations.

The challenges are formidable. But the importance of efficient economic union for the prosperity of Canadians remains as true today as it was 130 years ago when Sir John A. Macdonald said: "Whatever you do, adhere to the Union — we are a great country, and shall become one of the greatest if we preserve it: we shall sink into insignificance and adversity if we suffer it to be broken." The Union has endured and prospered, and indeed Canada has become "one of the greatest" countries. By meeting the ongoing challenge to manage our interdependence within the economic union more effectively, as our first Prime Minister foresaw so clearly, Canada can become more prosperous still.

This document's first chapter describes the benefits that have been realized from economic union, the characteristics that have generated these benefits and the areas in which there is need for improvement. Chapters 2 and 3 address proposals for making improvements in the areas of the internal market and the co-ordination, harmonization and transparency of macroeconomic policies.

## 1.2 Benefits of Economic Union

Federalism has put in place an economic framework that has made Canada one of the most prosperous countries in the world. We have consistently achieved an enviable record of wealth, income and job creation. And even greater economic performance is possible. However, failure to secure and enhance economic union could fairly quickly put what has been gained at risk.

The following data illustrate the success of the Canadian experiment:

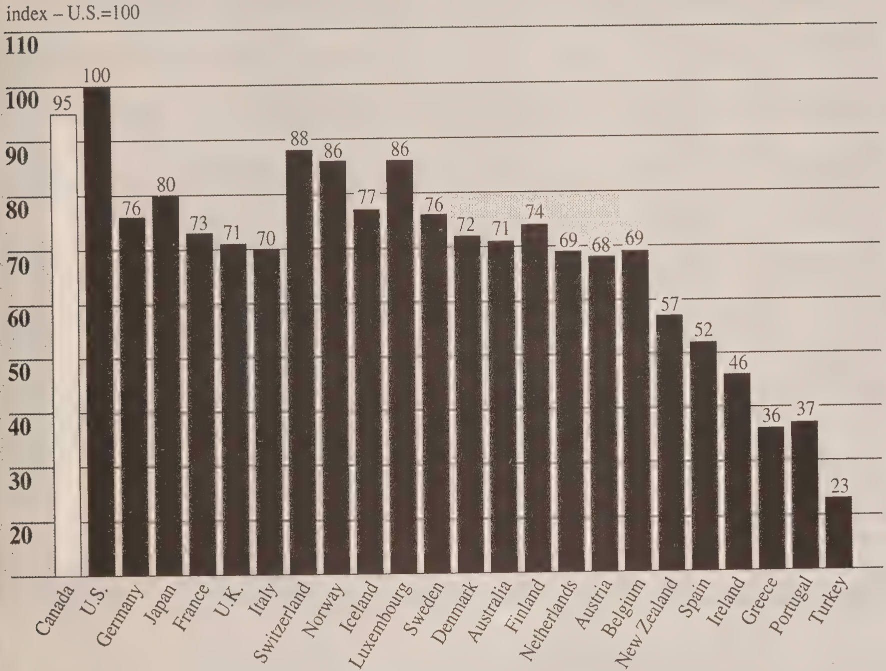
- we are the seventh largest industrial economy in the world, and have the second highest standard of living, behind the United States (Chart 1.1);
- we have the second best quality of life according to the United Nations' Human Development Index, which takes account of a variety of economic and social criteria (Table 1);
- we have, over the past 30 years, recorded the second highest rate of economic growth behind Japan among the Group of Seven (G-7) and the seventh fastest among the OECD countries (Table 2);
- we have had the second highest rate of growth of investment among the G-7 countries in the last 30 years (Table 3);
- we have achieved the fastest rate of job creation in the OECD over the last 30 years (Table 4) and the largest increase in the employment-to-population ratio in the last 30 years;
- we have the third highest level of labour productivity in the world after the United States and the Netherlands (Table 5).

Canada's impressive economic performance, and its continuation, is related to maintaining and enhancing the effective operation of the Canadian federal system. Certainly Canadians can be proud of this performance; equally certainly, we must not be complacent in the face of the new challenges, both global and domestic, that have emerged.

## 1.3 Federalism and Economic Union

Efficient economic union permits economies of scale, both in the provision of government services and in the pattern of production in the private sector. Two key elements go hand-in-hand: a high degree of economic integration and an advanced degree of political integration.

*Chart 1.1*
***Standard of Living Measure for 1990***
***Per Capita Real GDP Deflated by Purchasing-Power Parity***




Source: OECD, *Main Economic Indicators*, March 1991.

Purchasing-power parity (PPP) is defined by the OECD as "the rates of currency conversion that equalize the purchasing power of different currencies". This means that a given sum of money, when converted into different currencies at the PPP rates, will buy the same basket of goods and services in all countries.

- Adjusted for purchasing-power parity (PPP), Canada's per capita real GDP, at 95 per cent of U.S. per capita real GNP, was the second highest among the OECD countries in 1990.

*Table 1*
***United Nations' Human Development Index***

| | Rank | | |
|---|---|---|---|
| | 1970 | 1985 | 1990 |
| Japan | 9 | 1 | 1 |
| **CANADA** | **7** | **6** | **2** |
| Iceland | 3 | 2 | 3 |
| Sweden | 1 | 4 | 4 |
| Switzerland | 6 | 3 | 5 |
| Norway | 2 | 4 | 6 |
| United States | 12 | 10 | 7 |
| Netherlands | 3 | 7 | 8 |
| Australia | 11 | 8 | 9 |
| France | 8 | 9 | 10 |
| United Kingdom | 10 | 12 | 11 |
| Denmark | 5 | 11 | 12 |
| Finland | 17 | 13 | 13 |
| Germany | – | – | 14 |
| New Zealand | 12 | 15 | 15 |
| Belgium | 14 | 14 | 16 |
| Austria | 17 | 19 | 17 |
| Italy | 19 | 17 | 18 |
| Luxembourg | 15 | 15 | 19 |
| Spain | 29 | 18 | 20 |
| Ireland | 16 | 20 | 21 |
| Greece | 21 | 21 | 22 |
| Portugal | 22 | 22 | 23 |
| Turkey | 23 | 23 | 24 |

| | G-7 countries | | |
|---|---|---|---|
| | 1970 | 1985 | 1990 |
| Japan | 3 | 1 | 1 |
| **CANADA** | **1** | **2** | **2** |
| United States | 5 | 4 | 3 |
| France | 2 | 3 | 4 |
| United Kingdom | 4 | 5 | 5 |
| Germany | – | – | 6 |
| Italy | 6 | 6 | 7 |

- According to the United Nations' Human Development Index – a summary measure of national income, literacy and longevity – Canada ranked second among the OECD countries in 1990. Only Japan had a higher ranking.
- Canada's ranking improved from seventh in 1970 and sixth in 1985.

*Table 2*
### *Growth in Real GDP/GNP*
*(Average annual rate, per cent)*

| | Total OECD | | | |
|---|---|---|---|---|
| | 1961-1970 | 1971-1980 | 1981-1990 | 1961-1990 |
| Japan | 10.4 | 4.7 | 4.4 | 6.5 |
| Turkey | 5.7 | 4.9 | 5.1 | 5.2 |
| Portugal | 6.4 | 4.9 | 2.6 | 4.6 |
| Spain | 7.3 | 3.5 | 2.9 | 4.6 |
| Greece | 7.6 | 4.7 | 1.6 | 4.6 |
| Iceland | 4.7 | 6.5 | 2.0 | 4.4 |
| **CANADA** | **5.1** | **4.6** | **3.0** | **4.2** |
| Norway | 4.2 | 4.7 | 3.3 | 4.1 |
| Italy | 5.7 | 3.8 | 2.4 | 3.9 |
| Finland | 4.8 | 3.5 | 3.3 | 3.9 |
| Australia | 5.2 | 3.2 | 3.3 | 3.9 |
| France | 5.6 | 3.3 | 2.2 | 3.7 |
| Belgium | 5.0 | 3.3 | 2.0 | 3.4 |
| Austria | 4.5 | 3.6 | 2.2 | 3.4 |
| Ireland | 4.2 | 3.9 | 1.8 | 3.3 |
| Netherlands | 5.1 | 2.9 | 1.7 | 3.2 |
| Luxembourg | 3.5 | 2.6 | 3.4 | 3.2 |
| Germany | 4.5 | 2.7 | 2.2 | 3.1 |
| United States | 3.8 | 2.8 | 2.7 | 3.1 |
| Denmark | 4.3 | 2.2 | 1.8 | 2.8 |
| Sweden | 4.7 | 1.9 | 2.0 | 2.8 |
| Switzerland | 4.7 | 1.4 | 2.0 | 2.7 |
| United Kingdom | 2.8 | 2.0 | 2.7 | 2.5 |
| New Zealand | 3.4 | 1.8 | 1.9 | 2.4 |
| **OECD Average** | **5.3** | **3.3** | **2.9** | **3.8** |

| | G-7 countries | | | |
|---|---|---|---|---|
| | 1961-1970 | 1971-1980 | 1981-1990 | 1961-1990 |
| Japan | 10.4 | 4.7 | 4.4 | 6.5 |
| **CANADA** | **5.1** | **4.6** | **3.0** | **4.2** |
| Italy | 5.7 | 3.8 | 2.4 | 3.9 |
| France | 5.6 | 3.3 | 2.2 | 3.7 |
| Germany | 4.5 | 2.7 | 2.2 | 3.1 |
| United States | 3.8 | 2.8 | 2.7 | 3.1 |
| United Kingdom | 2.8 | 2.0 | 2.7 | 2.5 |
| **G-7 Average** | **5.3** | **3.3** | **2.9** | **3.8** |

- Canada averaged a 4.2 per cent growth rate in GDP between 1961 and 1990. Over the last 10 and the last 30 years, this was the seventh highest GDP growth rate among the OECD countries.
- Compared to the G-7 countries, Canada ranked second in terms of GDP growth over the last 30 years. Canada's GDP growth rate was lower during the 1980s than in previous decades, as it was in all of the G-7 countries except the United Kingdom; but Canada's 3.0 per cent growth rate was still second only to Japan's.

*Table 3*
***Real Gross Domestic Private Investment Growth***
*(Includes housing)*
*(Average annual rate, per cent)*

| | G-7 countries | | | |
|---|---|---|---|---|
| | 1961-1970 | 1971-1980 | 1981-1990 | 1961-1990 |
| Japan[1] | 16.2 | 2.7 | 6.7 | 8.5 |
| **CANADA** | **4.9** | **7.1** | **3.8** | **5.2** |
| United States | 4.0 | 3.3 | 3.0 | 3.4 |
| United Kingdom | 5.2 | 0.4 | 3.9 | 3.1 |
| Germany | 4.4 | 1.4 | 1.9 | 2.6 |
| France[2] | – | 2.5 | 2.2 | 2.4 |
| Italy[3] | – | 2.1 | 1.7 | 1.9 |
| **G-7 Average** | **6.8** | **2.8** | **3.5** | **4.1** |

[1] Data available from 1961 to 1989, columns 3 and 4 adjusted accordingly.
[2] Data available from 1971 to 1990, column 4 adjusted accordingly.
[3] Data available from 1971 to 1989, columns 3 and 4 adjusted accordingly.

- From 1961 to 1990, real investment growth averaged 5.2 per cent per year in Canada. This was second only to Japan and well above the average among the G-7 countries.

*Table 4*
***Employment Growth***
*(Average annual rate, per cent)*

| | Total OECD | | | |
|---|---|---|---|---|
| | 1961-1970 | 1971-1980 | 1981-1990 | 1961-1990 |
| **CANADA** | **2.9** | **3.1** | **1.6** | **2.5** |
| Iceland | 1.8 | 2.7 | 2.3 | 2.3 |
| Australia | 2.7 | 1.4 | 2.2 | 2.1 |
| United States | 1.8 | 2.4 | 1.8 | 2.0 |
| New Zealand | 2.2 | 1.6 | 0.3 | 1.4 |
| Turkey | 0.6 | 1.3 | 2.1 | 1.4 |
| Luxembourg | 0.6 | 1.2 | 1.7 | 1.2 |
| Japan | 1.4 | 0.8 | 1.2 | 1.1 |
| Portugal | -0.0 | 1.7 | 1.3 | 1.0 |
| Norway | 0.7 | 1.5 | 0.6 | 0.9 |
| Sweden | 0.6 | 0.9 | 0.6 | 0.7 |
| Switzerland | 1.5 | 0.1 | 0.6 | 0.7 |
| Denmark | 0.9 | 0.4 | 0.5 | 0.6 |
| Netherlands | 1.2 | 0.2 | 0.4 | 0.6 |
| Finland | 0.5 | 0.3 | 0.6 | 0.5 |
| France | 0.6 | 0.4 | 0.2 | 0.4 |
| United Kingdom | 0.2 | 0.2 | 0.8 | 0.4 |
| Greece | -0.8 | 0.7 | 0.9 | 0.3 |
| Belgium | 0.6 | 0.1 | 0.1 | 0.3 |
| Germany | 0.1 | 0.0 | 0.6 | 0.2 |
| Ireland | -0.0 | 0.9 | -0.3 | 0.2 |
| Italy | -0.4 | 0.6 | 0.4 | 0.2 |
| Spain | 0.7 | -0.6 | 0.6 | 0.2 |
| Austria | -0.5 | 0.3 | 0.4 | 0.1 |
| **OECD Average** | **1.2** | **1.4** | **1.2** | **1.2** |

| | G-7 countries | | | |
|---|---|---|---|---|
| | 1961-1970 | 1971-1980 | 1981-1990 | 1961-1990 |
| **CANADA** | **2.9** | **3.1** | **1.6** | **2.5** |
| United States | 1.8 | 2.4 | 1.8 | 2.0 |
| Japan | 1.4 | 0.8 | 1.2 | 1.1 |
| France | 0.6 | 0.4 | 0.2 | 0.4 |
| United Kingdom | 0.2 | 0.2 | 0.8 | 0.4 |
| Germany | 0.1 | 0.0 | 0.6 | 0.2 |
| Italy | -0.4 | 0.6 | 0.4 | 0.2 |
| **G-7 Average** | **1.3** | **1.5** | **1.3** | **1.3** |

- From 1961 to 1990, Canada had the highest employment growth rate, 2.5 per cent, of all OECD countries. No G-7 country was close to matching the average Canadian rate of employment growth.
- In the 1980s, Canada's employment growth rate slipped from first to sixth in the OECD. Among the G-7 countries, Canada had the second fastest rate of employment growth in the 1980s, just behind the United States.

*Table 5*
***Productivity Levels: Real GDP/GNP Per Employee***
*(Constant 1980 U.S. dollars, adjusted by purchasing-power parities)*

| | 1970 | 1980 | 1990 |
|---|---|---|---|
| United States* | 26,148 | 27,050 | 29,394 |
| Netherlands | 19,532 | 25,400 | 28,495 |
| **CANADA*** | **21,321** | **24,569** | **27,538** |
| Italy* | 16,223 | 22,149 | 26,289 |
| France* | 16,336 | 21,414 | 25,615 |
| Belgium | 15,718 | 21,265 | 24,960 |
| Norway | 14,806 | 20,131 | 24,881 |
| Luxembourg | 17,544 | 20,952 | 24,152 |
| Switzerland | 18,398 | 20,806 | 23,143 |
| Germany* | 15,575 | 20,254 | 23,143 |
| Spain | 12,308 | 18,276 | 22,254 |
| Japan* | 11,486 | 16,587 | 21,655 |
| Austria | 13,157 | 18,178 | 21,213 |
| Australia | 16,156 | 19,449 | 20,996 |
| United Kingdom* | 14,842 | 17,632 | 20,659 |
| Finland | 11,933 | 16,280 | 20,615 |
| Iceland | 15,015 | 21,719 | 20,461 |
| Sweden | 16,244 | 17,898 | 20,025 |
| Ireland | 10,072 | 14,619 | 19,908 |
| Denmark | 14,810 | 17,609 | 19,868 |
| New Zealand | 15,453 | 15,654 | 17,531 |
| Greece | 8,785 | 12,992 | 13,543 |
| Portugal | 7,609 | 10,159 | 11,426 |
| Turkey | 5,662 | 8,043 | 10,586 |

* G-7 countries.

- In terms of U.S. dollars adjusted for purchasing-power parity, Canada had the third highest GDP per employee level among the OECD countries in 1990, behind the United States and the Netherlands.
- From 1970 to 1990, among the G-7 countries, Canada steadily maintained the second highest level of GDP per employee.

At the heart of effective economic integration must be the absence of restrictions to the free flow of people, goods, services and capital and the existence of a common currency, which encourages this free flow by removing exchange rate uncertainty and transaction costs that can impede trade. Also important are uniform business framework laws, uniform work and product standards, co-ordinated and harmonized economic policies, and a co-ordinated and harmonized tax system.

Economic and political integration go hand-in-hand because, to maintain a high level of economic integration, each member of an economic association must be willing to modify its policies that are inconsistent with the economic objectives of the federation. Economic union with political integration also provides the structural basis for the sharing of income. As well, it provides a structure and incentives to deal with the difficult problem of "spillovers" where economic events and policy actions in one jurisdiction have unintended side-effects on other jurisdictions. A political union is also able to have greater influence in international dealings because of its larger size and the economic clout it can bring to the bargaining table.

Our high standard of living attests to the considerable strides Canada has made in developing each of these aspects of economic union. For example, there is considerable mobility of people, goods, services and capital in Canada. Some of the more important elements that facilitate current mobility include: a monetary union, no substantial border measures, common business framework laws, standardized weights and measures, and citizenship rights enshrined in the Constitution allowing settlement anywhere in Canada. The considerable mobility within the Canadian domestic economy is reflected in extensive interprovincial trade, migration and capital flows.

- Table 6 summarizes the interdependence of Canadian provinces for trade in goods. Many provinces are highly dependent on interprovincial trade; indeed Quebec, Nova Scotia, Prince Edward Island, Manitoba and Alberta are more dependent on interprovincial than on international trade. While data on the interprovincial flows of services are unfortunately not available, there appear to be few impediments.
- Table 7 shows that interprovincial migration flows are generally a more important source of population change in a province than international flows.
- Data on interprovincial capital mobility are not available. However, two indicators suggest that there are few barriers to capital mobility: (1) the fact that interest rates are equal in all Canadian provinces, and (2) the nature of the Canadian financial system which, with a branch network across provinces, allows instantaneous financial flows throughout Canada.

The facets of economic union that facilitate the relatively free flow of people, goods, services and capital have had an enormous impact not only on the structure of economic activity in Canada, but also in raising Canadians' incomes, accounting for many of the benefits discussed in the previous section. While direct estimates of the contributions are not available, inferences can be drawn from estimates made for the European Economic Community (EEC), which is moving to secure some of the benefits from economic integration that Canadians already enjoy. Such calculations confirm that economic union has greatly increased the prosperity of Canadians.

*Table 6*
***Current Dollar Exports of Goods by Destination in 1984***
*(As per cent of total exports)*

| | Interprovincial trade | International trade | Memo item: total exports/GDP |
|---|---|---|---|
| Newfoundland | 24.0 | 76.0 | 30.6 |
| P.E.I. | 59.9 | 40.1 | 29.7 |
| Nova Scotia | 54.6 | 45.4 | 32.1 |
| New Brunswick | 44.7 | 55.3 | 47.4 |
| Quebec | 51.7 | 48.3 | 35.2 |
| Ontario | 36.7 | 63.3 | 44.9 |
| Manitoba | 59.2 | 40.8 | 32.3 |
| Saskatchewan | 35.4 | 64.6 | 54.1 |
| Alberta | 61.1 | 38.9 | 50.3 |
| B.C. | 23.2 | 76.8 | 26.4 |

Source: Unpublished Provincial Input-Output Data, Input-Output Division, Statistics Canada.

*Table 7*
***The Contribution of Domestic and International Migration to Population Growth (1981-1986)***

| | Migrants by source: Other provinces | Other countries | Total | Percentage distribution of migrants: Other provinces | Other countries | Memo item: ratio of total inflows to total population increase |
|---|---|---|---|---|---|---|
| CAN. | 924,495 | 463,900 | 1,388,395 | 66.6 | 33.4 | – |
| NFLD. | 17,090 | 1,675 | 18,765 | 91.1 | 8.9 | 3.2 |
| P.E.I. | 9,480 | 890 | 10,370 | 91.4 | 8.6 | 2.8 |
| N.S. | 54,985 | 7,895 | 62,880 | 87.4 | 12.6 | 2.5 |
| N.B. | 36,525 | 5,045 | 41,570 | 87.9 | 12.1 | 2.7 |
| QUE. | 66,915 | 72,435 | 139,350 | 48.0 | 52.0 | 1.1 |
| ONT. | 285,525 | 221,325 | 506,850 | 56.3 | 43.7 | 1.2 |
| MAN. | 56,680 | 19,315 | 75,995 | 74.6 | 25.4 | 2.3 |
| SASK. | 54,695 | 8,880 | 63,575 | 86.0 | 14.0 | 1.8 |
| ALTA. | 177,290 | 55,990 | 233,280 | 76.0 | 24.0 | 2.1 |
| B.C. | 151,680 | 69,610 | 221,290 | 68.5 | 31.5 | 1.8 |
| YK. | 4,620 | 280 | 4,900 | 94.3 | 5.7 | 39.2 |
| N.W.T. | 9,010 | 560 | 9,570 | 94.2 | 5.9 | 1.7 |

Source: *Mobility Status and Interprovincial Migration*, Statistics Canada, 1986 Census (93-108).

- The Commission of the European Communities has estimated that the creation of the internal market planned for Europe for 1992 will raise average European incomes by at least 6.5 per cent. The European monetary union is expected by the Commission to raise incomes a further 5 to 10 per cent. (See *European Economy*, October 1990, pages 75 and 83.)
- Applied to Canada, these estimates suggest that economic union generates a permanent increase in living standards of at least 11.5 to 16.5 per cent for an average Canadian, or an average of about $11,000 to $16,000 per year in 1990 dollars for a family of four. These gains are attributable to less costly production due to exploitation of economies of scale and greater competitiveness. These estimates likely underestimate the total gains considerably because account is not taken of the positive impact over time on business and labour behaviour and capital formation which would yield further gains in real incomes.

The structure of Canadian federalism provides a number of arrangements to deal with so-called spillover problems, where events or actions in one jurisdiction affect others.

- For example, the federal government has constitutional authority for competition policy and intellectual property protection. In other cases, the economic union facilitates the resolution of spillover problems through mechanisms such as the federal transfer system. Areas of environmental concern such as acid rain pollution are an example where the federal government can and does play a role in spillovers across jurisdictions in Canada and in addressing spillovers across international boundaries.

Economic union raises productivity and incomes by making available a much larger market for producers in all provinces than the limited market each province provides. This encourages larger and more efficient plants and distribution systems, reducing both private and public sector costs.

The size of the market created by economic union is also important for generating for Canada considerable international bargaining clout. With the seventh largest industrial economy in the world, Canada has a "seat at the table" in the G-7, is an influential member of the GATT, is represented on the board of directors of the International Monetary Fund and the World Bank, and is a major player at the OECD. We have been able to negotiate international agreements such as the Canada-U.S. Free Trade Agreement, and currently are participants in negotiations for a North American free trade agreement.

Economic union, reinforced by the structure of our federal system, helps to smooth the impact of economic shocks — such as the grain price shock of 1986 — to the benefit of all Canadians. It does so by providing stabilization and insurance benefits to the provinces and, in some cases, directly to individuals. Economic union provides insurance benefits for the citizens of Canadian regions similar to the way a private sector insurance scheme works for individuals. Regions with widely different economic structures have effectively "pooled" their resources. Through the integrated tax, transfer and stabilization structures that are integral parts of our federal system, regions help each other out automatically when one part of the country or another is adversely affected by an economic shock. With the widely varying industrial structures across provinces, this insurance principle has been, and remains, very important to the Canadian economy.

The greater stability of the Canadian economy provides benefits to all Canadians through a number of channels such as federal expenditures, both discretionary and automatic, and federal tax revenues.

- "Fiscal insurance" is provided through national taxation and spending, including unemployment insurance, that is less volatile than for any province; Canada's borrowing costs are lowered because of the greater diversity; the federal government can stabilize activity or incomes in certain areas — for example, the agricultural sector — beyond the capacity of individual regions; and the federal government can in effect pool resources from the larger economic base of the country as a whole to mobilize capital for major undertakings — for example, the development of the railways, the St. Lawrence Seaway, a national airport system, etc.
- Empirical tests of the volatility of two key measures of economic activity — growth in real gross domestic product and employment — confirm that the national economy is much more stable than regional and provincial economies. For example, over the last 30 years the quarterly volatility of real output and employment growth has been significantly less at the national level than for any of the provinces individually. This provides a more

stable aggregate economy for transfers to smooth volatility in incomes in provinces and regions. It indicates the greater economic stability of the whole compared to the parts.

A major advantage of federalism (and one that is not available in less integrated forms of economic associations) is the opportunity it provides to co-ordinate and harmonize economic policies. Such policy co-ordination is essential for good economic performance, since economic policies in one jurisdiction can have substantial economic effects on other jurisdictions. Over time, Canada has put in place a number of mechanisms, both formal and informal, to help in the co-ordination of federal and provincial policies. Taxation is a good example of a policy area that significantly influences economic performance and where intergovernmental co-ordination is essential for effective economic union.

- All Canadians benefit from intergovernmental co-ordination in the income tax field. Individuals and businesses can earn income in more than one province and generally report it under a uniform set of rules. Canadians often deal with only one tax administration. Moreover, investment, dividends and interest income can flow from one province to another, generally unimpeded by taxes.
- The co-ordination of income taxes for the most part is achieved through co-operative agreements — the Tax Collection Agreements — with participating provinces. The Tax Collection Agreements work in conjunction with a general agreement among all provinces to use a common set of rules for the allocation of taxable income across jurisdictions — thereby ensuring that income is not double-taxed, nor able to escape tax. In this respect, Canada compares favourably to the United States, which has more complex rules for allocation of income among states, or the European Community, which has 12 distinct tax codes and separate tax administrations. Income tax co-ordination is thus a major asset of Canadian federalism, facilitating the free flow of goods, services, capital and people across jurisdictions.

While current co-ordination arrangements have achieved a measure of success — federal-provincial co-ordination in the income tax field is a case in point — there is still room for improvement in other areas. These include interprovincial barriers to trade and commerce, financial-sector regulation, sales taxes, and macroeconomic policy co-ordination, to name a few.

Canadian federalism has been valuable in not only generating sizeable economic gains but also in facilitating the sharing of these benefits between individual Canadians and among Canadian regions. The federal equalization program and the progressive income security system have been important elements of this process of sharing.

- The equalization program ensures that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. In the seven provinces receiving equalization — Newfoundland, Nova Scotia, Prince Edward Island, New Brunswick, Quebec, Manitoba and Saskatchewan — equalization payments account for between about 10 and 30 per cent of their total revenues.
- Through a progressive income tax structure and income-related transfers from governments, such as the Child Tax Credit and the low-to-modest income GST credit, policies have been developed to reflect the Canadian commitment to a sharing society.
- Further, by drawing on the greater resources available from the entire country,

Canadians have been able to express their sense of sharing through programs of assistance to disadvantaged areas of the country.

### 1.4 Where the System Can be Improved

For all the gains we have secured through federalism, Canada risks slipping back at a time when many other countries are pushing ahead aggressively in adapting to new international market forces by enhancing competitiveness and recognizing the need for consistent and co-ordinated government policies. If Canadians are to continue to enjoy strong economic growth and a standard of living at the leading edge in the world, we must not lag behind these international responses. We must respond to the challenges of the future, and address outstanding weaknesses of the past. To solve these problems will require a concerted effort on the part of all stakeholders in the Canadian economy — business and labour as well as all levels of government.

Governments must shoulder much of the responsibility for our economic union falling short of its potential. There are government-imposed barriers to competitiveness and to the free flow of goods, services, people and capital; there is inadequate intergovernmental policy co-ordination; and there is a lack of transparency of economic policies. The rest of this document deals with these subjects. It elaborates the proposals for reform that the Government of Canada has put forward in **Shaping Canada's Future Together: Proposals** to modernize Canada's institutional framework in each of these areas.

A range of interprovincial barriers to mobility has arisen through federal and provincial government actions. These barriers range from discrimination against non-provincial suppliers in public purchasing policies to restrictions on the free movement of qualified tradespeople between provinces. An oft-cited example of a restriction to the mobility of goods is the absence of free interprovincial trade in beer, which results in the paradoxical situation where, for example, someone from Newfoundland can more easily buy in the United States than at home a preferred brand of beer brewed elsewhere in Canada.

Such barriers reduce competition, increase the cost of doing business, result in higher prices for consumers, and increase the cost of government services — in short, they reduce our standard of living. Some estimates place the economic loss in excess of 1 per cent of GDP, or as much as $1,000 each year for a family of four. In addition, internal barriers such as preferential hiring practices for local residents over citizens from other regions of Canada detract from the common "rights" of citizenship that people in other countries take for granted.

Chapter 2 discusses in more detail the impediments to mobility that exist in Canada. It also elaborates on the proposals to remove barriers and restrictions to the mobility of people, goods, services and capital.

Better co-ordination of macroeconomic policies is another requirement if we are to maintain and enhance the benefits of federalism in the decades ahead. Governments have become very large players in the Canadian economy, and the processes for policy formulation and co-ordination should recognize this. Spending by the total government sector is 46 per cent of GDP, and total government revenues are 43 per cent of GDP. These figures compare to 29 and 27 per cent respectively only 30 years ago. Provinces, in particular, have had quite rapid growth in their influence on the economy; collectively, including their local and hospital sectors,

they now spend almost 70 per cent more money on programs than the federal government (see Chart 3.2).

While processes to address the co-ordination of fiscal policies exist, they have not evolved in pace with the rising importance of the government sector, nor with the increasing complexity of managing interdependence and the changing relative sizes of the levels of government. Nor has there been sufficient harmonization of fiscal policies with monetary policy.

Unco-ordinated macroeconomic policies can operate at cross purposes. They can frustrate the objectives of each government and make it very difficult and often quite costly to achieve broad economic objectives for the country as a whole. Poor co-ordination of fiscal policies across jurisdictions also leads to overlap and duplication and a less-than-optimal provision of public services for the taxpayers' money.

Chapter 3 therefore identifies a number of ways to improve the co-ordination of fiscal policies across governments and the harmonization of fiscal policies with monetary policy. These include the formalization of an annual cycle of meetings of federal and provincial Finance Ministers; making the budget deliberation processes of all governments more open, both to other jurisdictions and to the public; and the adoption of guidelines to improve the co-ordination of fiscal policies and the harmonization of fiscal policies with Canada's monetary policy. These changes in the processes to policy co-ordination would facilitate improved policy outcomes.

Greater openness and transparency of economic policy-making are necessary. Citizens seek to better understand, and to provide more input into, policy decisions.

Chapter 3 also elaborates on the proposals to open the budget process of all governments and increase public awareness of the objectives and results of economic policy and its implications for Canadians. A proposed new monitoring agency would provide independent and impartial advice to the Ministers of Finance of the federal and provincial governments and would publish comprehensive reviews of the macroeconomic policies pursued by all governments. This will help to inform the public and provide the basis for greater understanding and input. Proposals to clarify the mandate of the Bank of Canada, to enhance its Board of Directors and to strengthen the communication of monetary policy objectives are also explained.

# Chapter 2

# Managing the Internal Market: Enhancing the Mobility of People, Goods, Services and Capital

## 2.1 Introduction

Our abilities as Canadians to take advantage of economic opportunities in any part of the country — to work, to invest our savings, to sell our goods and services — are critical to our economic well-being. Without these abilities, many of our resources would be wasted. Our skills would not be applied in the most productive ways. Our living standards would not be as high as they could be.

In Canada, we have done reasonably well in achieving a high level of mobility of people, goods, services and capital. And indeed, this mobility has generated significant benefits for all Canadians.

But we have not done as well as we could have. There exist a number of barriers and restrictions to mobility. These constitute impediments to the operation of a fully integrated national market where goods, services, people and capital can move without discrimination. They impose costs on taxpayers and consumers; they weaken the competitiveness of Canadian industry; they can diminish our rights of citizenship; and they can damage our national identity.

In the past, governments have often overlooked the costs of internal barriers. In some cases, they have recognized the broader costs but judged them to be tolerable in view of the benefits accruing to specific beneficiaries — individuals, groups or regions. In recent years, however, the balance between the perceived costs and benefits of internal barriers has begun to change. In part, this is a result of the growing recognition of how internal barriers impose costs on Canadians — on consumers, on taxpayers and on firms. Focus on these costs is being brought into sharper relief as, in many respects, Canada is making more progress in reducing external barriers to the flows of products and factors of production than it is in reducing internal barriers. There is also a growing recognition that the relative importance of these costs is increasing as our international competitors (e.g., the European Economic Community) take significant steps to eliminate their own internal barriers and create fully integrated internal markets.

Impediments to mobility arise through the actions of both the federal and provincial governments. They can result from poor co-ordination among governments — for example, a failure to account for the impact that targeting on a local objective has on other jurisdictions and the national economy. Impediments include intentionally discriminatory policies — such as preferential treatment for local suppliers in public purchasing — or policies that, unintentionally, create impediments to mobility — such as non-harmonized regulation of environmental standards. Duplication of regulation, or lack of harmonization of regulation between

governments, such as occurs in some parts of the financial sector, can also act as an impediment to the ability of firms to compete effectively across Canada, to the detriment of consumers.

Some of these impediments are an inevitable and enduring feature of the Canadian federation, where many areas of responsibility are shared by federal and provincial governments. Mobility will never be perfect in such a situation. This being said, internal barriers are significantly greater in Canada than in many other federal systems.

Concerns about these barriers and their costs are being expressed more and more frequently. Many private and public groups have argued that internal barriers are an increasingly costly problem and have called on governments to take concerted action to address the problem. For example, the Royal Commission on the Economic Union and Development Prospects for Canada (Macdonald Commission) pointed to numerous internal market barriers that hamper the ability of Canadian firms to conduct business across the country and that create direct and indirect costs for all Canadians. The Consumers' Association of Canada has echoed these concerns in identifying internal barriers as a source of increased costs to Canadian consumers.

More recently, many business organizations — including the Canadian Chamber of Commerce, the Business Council on National Issues, the Canadian Construction Association, and the Canadian Manufacturers' Association — have argued strongly that interprovincial trade barriers are weakening our international competitiveness and effectiveness. The C.D. Howe Institute has also found that internal trade barriers impair our competitiveness and should be reviewed with a view to enhancing mobility and creating a stronger Canadian market.

Strengthening the internal market requires more than eliminating barriers. Because a number of economic policy areas are, and should continue to be, shared by different governments, improved ways to manage interdependence are also required. A key example is the need to better manage interdependence in financial-sector regulation. The financial sector facilitates the flow of funds from lenders to borrowers and from savers to investors. How well it works affects the competitiveness of all Canadian businesses, large or small. It is therefore essential that Canada's financial sector be sound, innovative, dynamic and internationally competitive.

Financial-sector regulation and supervision must be as effective and clear-cut as possible to minimize problems, to deal with them quickly when they occur, and to protect individual Canadians and the integrity of financial markets. There are few barriers to the free flow of capital in Canada, but the lack of harmonization of regulatory standards makes our financial sector less competitive than it should be. A number of commentators have called for better management of financial regulation between jurisdictions.

Against this background, the federal and provincial governments have made numerous attempts over the last decade to find solutions. Results have been slow in coming and limited in effect.

The balance of risks is now clearly shifting against the desirability of many of our internal barriers and our ability to sustain them; there is growing evidence to suggest that our international competitiveness, and more fundamentally our jobs, could be threatened if more concerted and effective action is not taken. In the April 1991 Throne Speech, the Government of Canada undertook to work with provincial governments to eliminate interprovincial barriers by 1995, so that Canada becomes a single, integrated

internal market from coast to coast. The proposals of the Government of Canada are designed to move the country closer to that goal.

## 2.2 Costs of Barriers

Although a definitive list of internal barriers does not exist, one recent study (by the Canadian Manufacturers' Association) argued that there were at least 500 government impediments to the mobility of goods, services, people and capital in Canada. Both the federal and provincial governments — acting individually or jointly — are responsible for the laws, practices and policies that create impediments to the operation of a fully integrated national market. For example, the range of impediments created by governments includes:

- procurement practices that favour local suppliers over lower-cost out-of-province suppliers;
- policies favouring local wine, liquor, and beer industries over out-of-province producers;
- agricultural supply marketing boards that regulate the production and prices of various food products including milk, poultry and eggs;
- regulations that effectively restrict the ability of firms to operate freely across provincial boundaries;
- health, safety, and labelling standards that differ by province;
- hiring policies that favour local residents over those from other provinces;
- standards for professionals and tradespeople that restrict employment opportunities for residents of other provinces; and
- use of provincial limitations on certain financial investments to influence business decisions.

Although it is extremely difficult to measure precisely the overall effect of such barriers on the national economy, efforts to quantify existing costs point to a significant national economic burden.

- The Macdonald Commission cited estimates ranging as high as 1.5 per cent of GNP for the total cost of internal trade barriers for the national economy.
- More recently, the CMA suggested that savings from the elimination of barriers could be as high as $6 billion (just under 1 per cent of GDP), or almost $1,000 per year for a family of four.

These estimates do not capture the costs associated with new activity that is deterred as a result of the existence of barriers. For example, existence of internal barriers — and the knowledge that new ones can be introduced at any time — can deter Canadian businesses and entrepreneurs from undertaking new investments based on the expectation of access to the whole Canadian market. Similarly, the existence of internal barriers may discourage international investors, who seek to locate their plants in fully integrated markets, from bringing their productive investments to Canada.

While these aggregate costs are important for the economy as a whole, the specific and direct costs borne by Canadian individuals and firms are much more tangible. One need not look very far to find that such barriers have a direct impact, whether on a small or large business, a consumer purchase, or an individual's tax return.

As consumers, Canadians pay higher prices for many goods and services — food and telecommunications, for example — as a result of internal barriers. As taxpayers, Canadians pay higher taxes to cover the premium that governments often pay for goods and services in order to favour local employment and development. As workers,

Canadians are restricted by preferential hiring practices in their opportunities to move to where they can earn the best livelihood.

In the private sector, barriers limit the ability of Canadian firms to utilize the whole Canadian market to achieve the most efficient production and to realize their full competitive potential. They increase costs and may deter firms from reaching a size or level of efficiency where they could be effective international competitors.

Although these policies are often intended to assist smaller firms, in practice they can make it difficult, and in some cases impossible, for small business to grow. This in turn means that business costs will likely be higher than need be and will be passed on to consumers in the form of higher prices or, when goods are purchased by governments, in the form of higher taxes. It also means that the business sector is not able to create as many high quality jobs as it otherwise might. These restrictions can place small and large businesses at a disadvantage vis-à-vis international rivals. (For illustrations of how internal barriers can raise costs to governments, consumers and taxpayers, and impair our international competitiveness, see the Annex.)

Government policies that sanction preferential hiring practices can restrict the ability of Canadians to seek jobs wherever they are offered. These restrictions impose costs on those seeking jobs and also reduce the ability of employers to find the best qualified labour.

## 2.3 Pressures for Change

Many of our internal barriers arose from intentions to address particular objectives, in the areas of social policy, regional development, industrial development and so on. In many cases, however, there are less distorting and less costly ways to achieve such objectives. Internal barriers can impose significant costs on Canadian consumers and on the competitiveness of our firms, and these costs are becoming more evident. In addition to the direct economic costs, there are other, equally important, costs that may be too high.

Internal barriers are of particularly questionable value at a time when it is more important than ever to focus on the common interests of all the peoples and regions of Canada to successfully meet competitive challenges from abroad.

There is also a recognition that, in light of continuing trade liberalization and accelerating globalization of markets, the costs associated with internal barriers are becoming increasingly difficult to bear. The success of our principal competitors in creating fully integrated domestic markets with few barriers to internal trade can place Canadian firms at a fundamental disadvantage vis-à-vis their foreign rivals, and can significantly weaken the federal government's capacity to secure access for Canadian products in other markets.

Those federations that have been successful in limiting internal barriers — for example, the United States or Germany — typically have provisions in their constitutions that clearly set out the commitment to an internal common market and/or provide the federal government with a strong power to address barriers to trade. More dramatically, the European Community, a grouping of countries characterized by even greater regional economic, cultural, linguistic, and historical diversity than Canada, has introduced a program to institute a fully integrated market by the end of 1992.

The ability of governments to "deliver" secure access to an integrated internal market strengthens their capacity to demand reciprocal access for their own products in foreign

markets. The existence of internal barriers within Canada, and the ability to erect new ones, can significantly weaken Canada's capacity to negotiate greater access for Canadian products from trading partners with more internally integrated markets.

The financial sector is a good example of these effects. The increasingly international scope of this sector makes it more important than ever to better manage interdependence within Canada. Globalization means that regulatory regimes of different countries are no longer isolated, and we cannot afford inefficient overlap and duplication of regulation; business will go elsewhere. As regulatory standards, supervision and enforcement are increasingly being conducted internationally, and as enhancing Canadian financial institutions' access to other markets becomes increasingly important, it is essential to take a clear co-ordinated approach in Canada's participation if it is to be effective.

At the same time as international pressures are increasing, there is a strong possibility that our difficulties with internal barriers may get worse in the future as a result of ongoing trends in government within Canada. Governments in general have grown significantly in Canada over the last 50 years. At the same time, the provincial governments have increased dramatically in size relative to the size of the federal government. This growth in the size and reach of governments raises both the risk and the cost of conflicting policies that intentionally, or unintentionally, give rise to internal barriers.

In short, if significant inroads are not made in eliminating internal barriers, Canada's economic prospects in the decades ahead will be diminished. As a country we will be poorer, with fewer resources at our disposal to meet our priorities. We may also find our international role diminished vis-à-vis our more dynamic competitors. And, we may find it increasingly difficult to keep individuals essential to our prosperity — entrepreneurs, professionals and skilled workers — within Canada.

## 2.4 A Framework for Action

In recognition of the growing costs of internal barriers — both economic and non-economic — governments in Canada have launched numerous efforts to reduce them over the last decade. In particular, there have been two important federal-provincial thrusts. First, since 1987, at the request of First Ministers, the Intergovernmental Committee of Ministers on Internal Trade has sought to reach agreement on the reduction of internal trade barriers in selected priority areas — government procurement, beer marketing, and wine and spirits. Second, federal and provincial agriculture ministers signed a Memorandum of Understanding in 1989 to consult on new regulations which could adversely affect the movement of agricultural and food products, and are now working on follow-up arrangements.

There have also been attempts among provincial governments to address specific kinds of internal barriers. The four Western provinces concluded an agreement, effective April 1989, for open tendering on government procurement, and the three Maritime provinces concluded a similar agreement, effective April 1990. In addition, in May 1991 the Council of Maritime Premiers issued a discussion paper on Maritime economic integration, noting that internal barriers within the region cost businesses and taxpayers money and made it more difficult for workers to get jobs. The Council proposed a systematic effort to remove barriers. More recently, at the Premiers' Conference in August 1991, it was announced that an agreement had been reached for all provinces to end provincial preferences on any goods procurement in excess of $25,000.

However, despite these efforts, progress has been modest. It has been modest largely for two reasons. First, governments in the past have generally been reluctant to address internal barriers. In addition, in many instances, governments have overlooked the economic costs of internal barriers to the broader Canadian economy or have seen them as tolerable in relation to the perceived benefits. In the past, this may have been because governments and the public were less aware of the full range of costs than they are today.

Second, the constitutional authority to address the problem is not clear. The federal government has not had clear constitutional authority to address the issue in a comprehensive and effective fashion; nor do individuals have the right to challenge governments on a wide range of actions that are perceived to be inconsistent with the principle of free mobility in Canada.

While the commitment to the internal market in the Canadian constitution may have been adequate in the mid-19th century, it is clearly out of step with Canada's requirements in 1991, and with constitutional provisions in other jurisdictions. Taken together, our "common-market clause" (section 121 of the *Constitution Act, 1867*) and the federal government's trade and commerce power (contained in section 91 of the *Constitution Act, 1867*) have, in practice, provided a weaker constitutional basis for a comprehensive approach to the problem of internal barriers than in other jurisdictions.

The current common-market clause has a very limited scope in that it applies only to the movement of goods, prohibits only the imposition of tariffs by one province on goods from another, and appears to constrain only provincial governments:

> All Articles of the Growth, Produce, or Manufacture of any one of the Provinces shall, from and after the Union, be admitted free into each of the other Provinces.

To address these shortcomings effectively will require political will on the part of all governments to pursue a comprehensive approach to the elimination of barriers, including new mechanisms to facilitate a collaborative effort among governments that balances the needs for leadership and co-operation. It will also require constitutional clarification and changes to expand the rights of Canadians to do business and earn income anywhere in Canada and to provide individuals with the capacity to challenge government action that denies them this right.

## 2.5 Proposals for Managing the Internal Market

*Proposals*

*The Government of Canada proposes that section 121 of the Constitution be modernized to enhance the mobility of persons, capital, services and goods within Canada by prohibiting any laws, programs or practices of the federal or provincial governments that constitute barriers or restrictions to such mobility....the amendment proposed to section 121 allows for exceptions for reasons of national interest, and would not apply to legislation promoting regional development or equalization. The Special Joint Committee should consider whether other exceptions to the proposed section 121 would be appropriate.*

*The Government of Canada, therefore, proposes that the Constitution be amended to provide Parliament with a new power to make laws for the efficient functioning of the economic union....federal legislation under this new power could not be enacted without*

*the approval of at least seven of the provinces representing 50 per cent of the population.*

The federal government's proposals to strengthen the internal market involve both constitutional and policy approaches.

In order to ensure that government practices do not create barriers or restrictions to the mobility of people, goods, services and capital on the basis of where in Canada they reside or originate, the government is proposing a broader and strengthened internal market clause in section 121. Such an amendment would reflect the commitment of both levels of government to the implementation and observance of a free internal market in their actions.

This proposal would involve the broadening of section 121 to deal with:

- barriers related to persons, goods, services and capital;
- both tariff barriers and non-tariff barriers;
- barriers created both by provinces and the federal government; and
- barriers arising from legislation, regulations and administrative practices.

A revised section 121 in the Constitution would empower private parties (individuals as well as firms) to challenge, through the courts, the actions of governments that are inconsistent with the principle of free mobility within the internal market:

*(1) Canada is an economic union within which persons, goods, services and capital may move freely without barriers or restrictions based on provincial or territorial boundaries.*

*(2) Neither the Parliament or Government of Canada nor the legislatures or governments of the provinces shall by law or practice contravene the principle expressed in subsection (1).*

At the same time, in recognition of the fact that an absolute prohibition is neither feasible nor desirable, an exception would be included to allow governments to continue to pursue legitimate policy goals to help alleviate regional imbalances:

*(3) Subsection (2) does not render invalid:*

*(a) a law of the Parliament of Canada enacted to further the principles of equalization or regional development;*

*(b) a law of a provincial legislature enacted in relation to the reduction of economic disparities between regions wholly within a province that does not create barriers or restrictions that are more onerous in relation to persons, goods, services or capital from outside the province than it does in relation to persons, goods, services or capital from a region within the province; or*

*(c) a law of the Parliament of Canada or of the legislature of a province that has been declared by Parliament to be in the national interest.*

*(4) A declaration referred to in paragraph (3)(c) shall have no effect unless it is approved by the governments of at least two-thirds of the provinces that have, in the aggregate, according to the then latest general census, at least 50 percent of the population of all the provinces.*

The Special Joint Committee will consider whether other exceptions would be appropriate.

A revised section 121, while potentially wide-ranging, may not address the full range of barriers. Certain impediments, such as those that arise as a result of differing regulatory practices, may not be characterized by the courts as being barriers or restrictions within the meaning of a revised section 121. As many of these are in areas of provincial

jurisdiction, they may also be outside of the purview of the federal government's trade and commerce power under section 91.

In addition, governments may wish to avoid the uncertainty, costs and time associated with addressing certain kinds of barriers through the courts by having recourse to an alternative forum for the resolution of these problems.

In this context, the federal government is proposing the creation of a new constitutional power for Parliament that would allow it to pass legislation for the efficient functioning of the Canadian economic union in areas beyond its existing jurisdiction:

*(1) Without altering any other authority of the Parliament of Canada to make laws, the Parliament of Canada may exclusively make laws in relation to any matter that it declares to be for the efficient functioning of the economic union.*

*(2) An Act of the Parliament of Canada made under this section shall have no effect unless it is approved by the governments of at least two thirds of the provinces that have, in the aggregate, according to the then latest general census, at least 50 per cent of the population of all the provinces.*

*(3) The legislative assembly of any province that is not among the provinces that have approved an Act of Parliament of Canada under subsection (2) may expressly declare by resolution supported by 60 per cent of its members that the Act of Parliament does not apply in the province.*

*(4) A declaration made under subsection (3) shall cease to have effect three years after it is made or on such earlier date as may be specified in the declaration.*

Through this new power, Parliament would have the scope to address not only barriers that would otherwise come under the courts' purview under an expanded section 121, but also barriers that do not result from explicit discrimination.

In order to ensure a co-operative approach to managing Canada's economic union, the federal government is proposing that legislation so enacted would have no effect unless ratified by a new Council of the Federation. To become effective, this legislation would need to be approved by two thirds of the provinces with 50 per cent of the population. Once approved by the provinces, this legislation would be binding on them. Dissenting provinces could opt out of the new federal law for a period of three years, but only by passing, with the support of 60 per cent of the members, specific legislation to that end in their legislatures. The Special Joint Committee will consider whether, and in what circumstances, this opting out provision should be renewable.

In order to provide governments with an opportunity to address the key problems of internal barriers in this new collaborative forum, the federal government is proposing that the new section 121 would be delayed in coming into force until July 1, 1995. During the intervening period, the federal government proposes that governments work together to eliminate as wide a range of barriers and restrictions as possible.

These proposals on the management of the internal market are a critical counterpart of the wider prosperity initiative which the federal government will soon launch. They are directed at governments and the impediments that they create to the efficient operation of the internal market. Failure by governments to take the necessary steps to reduce these barriers could jeopardize the ability of Canadian firms and individuals to reach their full potential and could reduce the future prosperity of Canadians.

## 2.6 Improving Financial-Sector Regulation

The financial sector is one important example of an area where better management of interdependence could benefit the economic union.

Regulation of the financial sector involves three types of measures: broad policy-setting by governments; detailed laws and regulations; and ongoing supervisory oversight and enforcement. Without basic harmonization of broad policies, it would be difficult to manage the interdependence that arises from shared jurisdictions. Harmonization of policies, and laws and regulation is not sufficient, however, if unnecessary duplication is to be avoided.

In the financial sector many provinces and the federal government have adopted policies to allow more competition and thus blur the distinction between different parts of the sector. With these developments we need to ensure that one jurisdiction does not act to negate another's policies and that unnecessary duplication is minimized.

Canada's multi-jurisdictional environment results in regulatory overlap and duplication, both between the federal government and the provinces and among the provinces. Also, in some areas of the financial sector, jurisdictions may not have the ability to address all regulatory concerns, or the time and effort required to achieve co-ordination among all relevant jurisdictions may mean that action is not as timely as it should be. Finally, there are increasingly instances where the effectiveness of Canadian representation in the international sphere should be enhanced.

## 2.7 Approaches to Better Managing Financial-Sector Regulation

*...The Government of Canada will work actively with the provinces in this area to clarify responsibilities. In this respect, the Government intends to address the issue of overlap and duplication in the regulation of trust companies. The federal government will also work closely with the provinces to develop more efficient and better coordinated corporate securities regulation which will be essential in an international environment where unnecessary duplication risks business going elsewhere. It will also be important for Canada to have a more effective presence in international groups dealing with securities matters.* (**Shaping Canada's Future Together: Proposals,** Page 31)

### *(a) Overlap and Duplication in Trust and Loan Company Regulation*

Trust and loan company regulation is characterized by overlap between the federal government and the provinces, and interprovincially.

As a result, a federally incorporated trust or loan company operating in Ontario and Quebec may be subject to three different regulatory regimes. A federally incorporated or provincially incorporated trust or loan company wishing to operate across the country could potentially face 10 or 11 sets of rules in its Canada-wide operations.

Such overlaps impose unnecessary costs on companies. This reduces their competitiveness and ultimately hurts consumers. Many have argued that Canada should adopt some version of Europe 1992, which envisages the creation of a single European financial market by next year. This would involve each jurisdiction recognizing and accepting, for regulatory purposes, the prudential regime of the jurisdiction within which a financial institution is chartered, subject to acceptable basic standards.

Provinces have been working to harmonize their regulatory regimes, but more work is required. The federal government is prepared to explore with the provinces the possibility of moving toward a regulatory regime based on lead jurisdiction or mutual recognition. For federally incorporated companies, such arrangement could be achieved by provinces delegating their administrative and regulatory power to the federal government.

### *(b) Securities Regulation*

Securities markets in Canada have been traditionally regulated by the provinces, and the regime has served Canada well. However, international pressures are forcing the pace of regulatory change and increasing the costs of not being able to keep up. For example, a Canadian company considering a Canada-wide share issue would have to clear its prospectus in each of the provinces. By contrast, under an agreement recently reached by the provinces and the U.S. national securities regulator, the same issuer could have access to the entire U.S. market with a single clearance of the same prospectus. Failure to develop an integrated, Canada-wide response to global pressures risks eroding the competitiveness of our securities markets. Decisions about securities regulation are increasingly linked to other economic and trade policies and, increasingly, securities regulation is becoming international in scope.

Historically, Canadians played a lead role in setting up the International Organization of Securities Commissions, an organization that is evolving into an international standard-setting body, facilitating international supervision. In an increasingly international environment, Canada may not be in a position to play as effective a role as desirable, as Canada is the only member country without a representative who can make decisions for the entire market.

Some have suggested that the federal government become responsible for securities regulation. It is not clear that this is essential. Indeed, others have suggested that all jurisdictions could delegate all or part of securities regulation to a jointly operated agency, as a means of dealing with potential gaps efficiently and avoiding duplication. The government is prepared to explore this or other approaches that could meet the kinds of concerns expressed above. These could include more formalized federal-provincial action to co-ordinate approaches to regulation, international negotiation and standard-setting involving securities matters.

# Chapter 3

# Managing Interdependence: Strengthening the Co-ordination and Harmonization of Macroeconomic Policies

## 3.1 Introduction

The public sector in Canada is very large. Spending of all levels of government is now 46 per cent of GDP compared to 29 per cent three decades ago. Governments have a profound influence on the economy, not only through their spending, taxation and debt management operations, but also through legislation and regulation that sets the broad framework under which the market economy operates. This fiscal influence is wielded by the federal government, 10 provincial governments and two territories, and the fiscal policies of each government have spillover effects — to greater or lesser extents — on all regions of the country. At the same time, the federal government, through the setting of monetary policy, has a key influence on all sectors of the Canadian economy.

In a federation that features economic union, there can only be a single monetary policy which, by definition, must be Canada-wide in scope. In contrast, federal and provincial governments have jurisdiction over the setting of their own fiscal policies, and no authority has responsibility for the aggregate fiscal policy stance of the country, which is the sum of the fiscal stances of all governments. A central issue is how we can ensure that fiscal policies do not work at cross purposes and, equally important, how we can ensure that the aggregate fiscal stance of the country is working in tandem, not at variance, with monetary policy.

Consistent and co-ordinated fiscal and monetary policies enhance the benefits that can be derived from economic union. On the other hand, when fiscal policies of the different governments are working against each other and/or the aggregate stance of fiscal policy is inconsistent with monetary policy, the costs to Canadians in terms of higher interest rates, reduced employment prospects and lost income can be very high.

While processes have been developed to facilitate the co-ordination of fiscal policies across governments and the harmonization of fiscal policies with monetary policy, they are not fully adequate to the task at hand. Two examples from recent Canadian economic history vividly illustrate the high costs to all Canadian citizens of unco-ordinated macroeconomic policies.

- The first example is the rapid increase in fiscal deficits the federal government incurred during the early 1980s. These large federal deficit increases, while provinces were generally acting to contain deficit pressures but not offset the federal stance, meant that the aggregate stance of fiscal policy was structurally unstable, leading to rapid increases in public sector debt, an increased dependence on foreign

savings and higher real interest rates. It also set in train a deficit-debt treadmill from which the country is still trying to extract itself and which has had significant ongoing implications for federal program spending, including transfers to provinces.

- A second example is provided by the expansionary fiscal policy pursued by the Ontario government over the 1986-89 period. The Ontario economy was booming and running against capacity constraints, yet the Ontario government rapidly increased spending. Ontario's policy made the Bank of Canada's task of reducing inflation more difficult and more costly to all Canadians. Inflation pressures were exported from Ontario to the rest of the economy, and national interest rates rose much more than would have been the case with a more appropriate Ontario fiscal policy. In turn the higher interest rates exacerbated the fiscal positions of all governments and complicated, in particular, the efforts of the federal government to control its deficit and debt.

These domestic examples, as well as numerous episodes in other countries, are a good illustration of the importance of three general factors which impair the performance of Canada's economy:

- a lack of effective co-ordination of federal and provincial fiscal policies;
- a lack of effective harmonization of fiscal policies with monetary policy; and
- a lack of transparency of the objectives and processes of fiscal policies and monetary policy.

At the international level, governments have long recognized that co-operation and co-ordination of macroeconomic policies are highly beneficial to the world community. In today's highly integrated financial and goods markets, governments can no longer ignore the international effects of their actions, or actions taken by others on them. An almost continuous stream of meetings of the OECD and IMF and of the G-7 countries provide an international framework for ongoing co-ordination and co-operation.

It is disturbing, however, that we have not managed to establish within Canada a comprehensive and effective system of co-ordination of macroeconomic policies. The challenge is to find better ways to manage our internal interdependence, to foster greater co-operation between governments and better co-ordination of fiscal policies and to ensure that overall fiscal policy and monetary policy are in harmony. Canadian taxpayers rightly expect governments to do their utmost to ensure that our economic union yields the greatest possible benefits. It is up to the governments, both federal and provincial, to rise to the challenge of defining and adopting a macroeconomic policy framework appropriate to the needs of our modern economy.

This chapter examines how policy co-ordination and harmonization could be improved through:

- new mechanisms that facilitate the co-ordination of federal and provincial fiscal policies, and foster greater consistency in overall fiscal policies and monetary policy;
- increased transparency and more openness in budget formulation processes;
- better communication of policies so that the public better understands what is being done and why; and
- a strengthened approach to policy monitoring, with a focus on systematically and impartially reviewing the various facets of Canadian macroeconomic policies at all levels of government.

Section 3.2 below reviews a set of proposals for improving the co-ordination of fiscal policies. Issues related to monetary policy

are reviewed in section 3.3. The contribution that could be made by an independent agency, charged with monitoring and advising on Canadian macroeconomic policies, is examined in section 3.4.

## 3.2 Better Co-ordination of Fiscal Policies

### *(a) Implications of Growth in the Public Sector*

The overall growth in the Canadian public sector, and the shift in the relative sizes of the federal and provincial governments, have important implications for policy co-ordination. As the total public sector has grown, and as the provincial governments have come to have a much more significant influence on the Canadian economy — in aggregate exceeding that of the federal government in terms of direct spending — the practical need for co-ordination has become much more acute over time.

The size of governments in the economy has grown considerably in the post-war period, and their influence has become pervasive (Chart 3.1). In 1990, spending by all levels of government was 46 per cent of GDP. Government accounted directly for 22 per cent of all final expenditures on goods and services; transfers to persons and businesses reached 14 per cent of GDP; and interest on the public debt amounted to almost 10 per cent of GDP. More than one third of GDP was transferred by the private sector in taxes to all levels of government.

During the last 30 years provincial and municipal governments have grown particularly rapidly (Chart 3.2). These levels of government, together with the hospital sector, vastly surpass the federal government in terms of direct spending power. In 1990, their expenditures on goods and services were slightly more than 3.5 times larger than those of the federal government. Spending on transfers to persons and businesses continues to be dominated by the federal government, but only by a small margin. Interest payments on public debt are almost twice as large at the federal level as for other levels of government combined.

The aggregate provincial-local-hospital sector collects more tax revenue than the federal government. As a ratio to GDP, total taxes collected by this sector have more than doubled in the past 20 years. Additionally, the federal government transferred an amount in 1990 equivalent to 23.8 per cent of its total revenues to the provincial-local-hospital sector, up from 16.4 per cent in 1960.

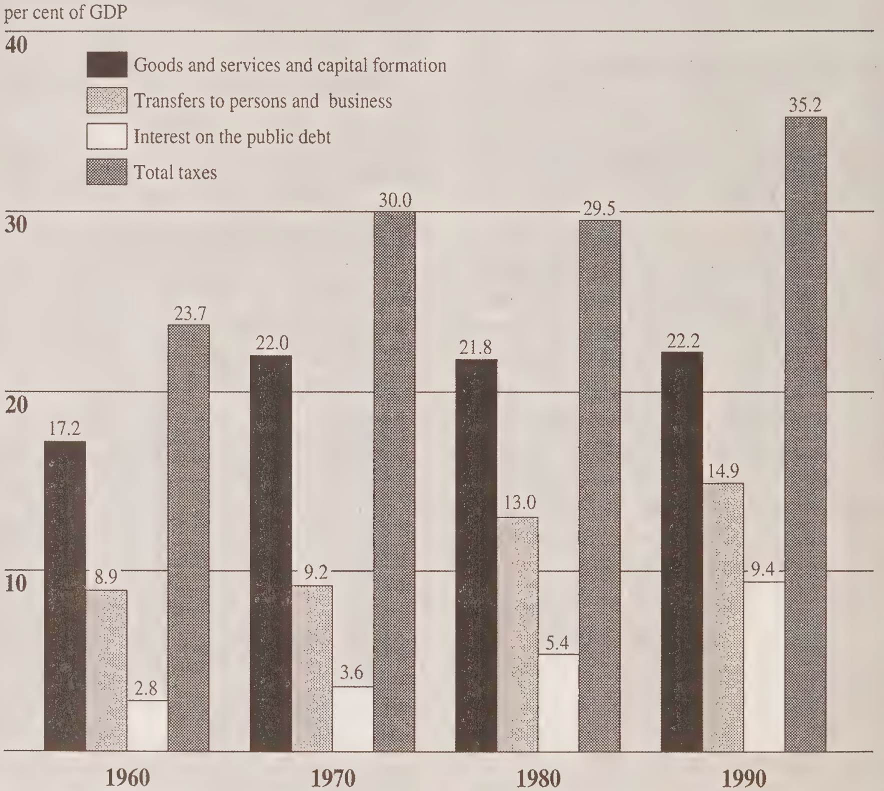
On a national accounts basis, combined federal and provincial-local-hospital debt has risen to 50 per cent of GDP in 1990, compared to 20 per cent at the beginning of the 1980s (Chart 3.3). Most of government debt in Canada is at the federal level, and most of the growth in the combined debt over the past decade has occurred at the federal level. In fact, as a ratio to GDP, the debt of the provincial-hospital-local sector has shown no trend over the past 30 years. However, debt burdens are quite high in certain provincial jurisdictions.

### *(b) How Fiscal Co-ordination has Worked in Canada*

Federal and provincial Finance Ministers' meetings now allow for an exchange of views on respective economic and fiscal outlooks. While there is usually considerable discussion of the problems identified in each jurisdiction, these meetings are not currently structured to address what a co-ordinated fiscal policy approach would mean and what it could achieve.

*Chart 3.1*

***Evolution of Total Public Sector* Expenditures and Taxes (National Accounts Basis)***




* The total public sector includes the federal government, provincial government, local government, the hospital sector and the Canada and Quebec pension plans.

Chart 3.2

**Comparison of Federal and Provincial-Local-Hospital Sector Expenditures and Taxes (National Accounts Basis)**

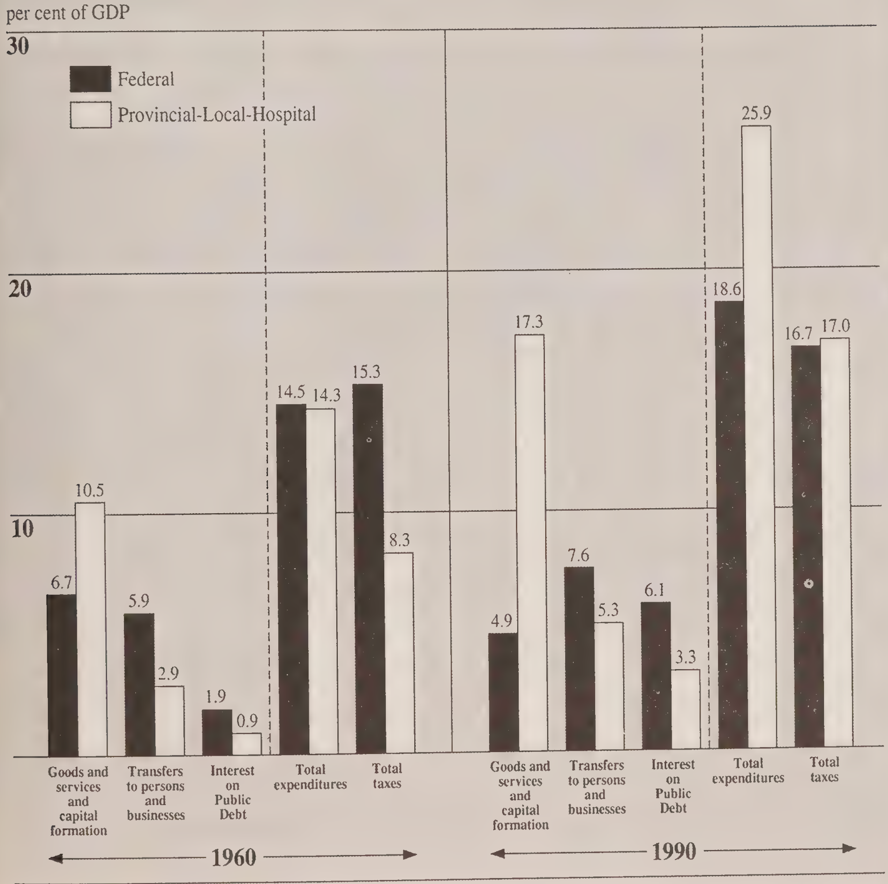
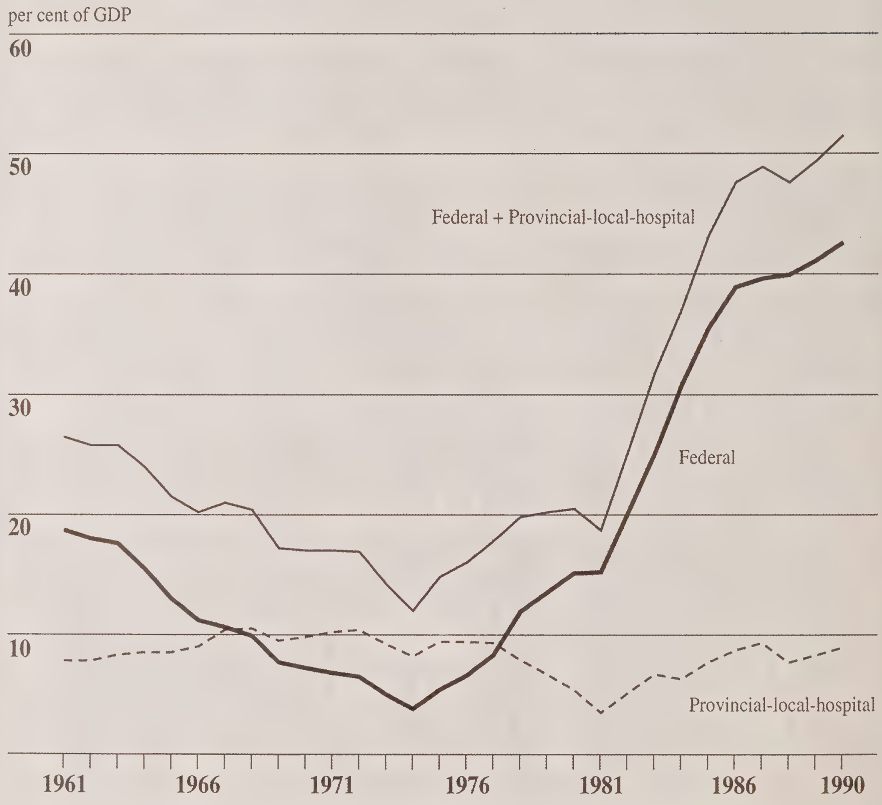


*Chart 3.3*
***Evolution of Government Sector's Net Debt (National Accounts Basis)***



The timing of the annual budget cycles and the rather closed nature of most budget processes also influence the potential scope of co-ordination. Provincial budgets typically follow the federal budget in the annual cycle, and hence are in a position only to react to federal policies. The federal budget is typically prepared with little information about forthcoming provincial fiscal policies. While there are federal-provincial discussions before federal budgets are brought down, factors such as budget secrecy, the absence of a more formal collaborative mechanism and the lack of clearly and publicly specified macroeconomic objectives have tended to limit the extent of intergovernmental fiscal deliberations.

The overall process precludes the simultaneous development of a co-ordinated fiscal policy approach. In short, there is inadequate interaction between the various governments as to the appropriate stance of aggregate fiscal policy and little chance to review, and discuss together, adjustments to Canadian fiscal policy.

Federal and provincial fiscal policies that are neither co-ordinated nor transparent imply that governments are often likely to work at cross purposes with each other. In aggregate, the fiscal policy stance may not be compatible with the objectives of monetary policy. Basic national objectives such as high and growing prosperity in a stable economic environment may become difficult or even impossible to realize. And to the extent that objectives are achieved, the costs borne by Canadians in order to achieve them are higher than they would be with greater co-ordination.

Some of the results of governments frustrating each other's actions and failing to provide co-ordinated economic guidance can be rising government deficit and debt levels, high interest rates, reduced capital stock and fiscal flexibility; depressed productivity, growth, real incomes and living standards; and an economy that is inflation-prone and slow to adjust to adverse economic shocks.

### *(c) Objectives of Policy Co-ordination and Harmonization*

Canadians are concerned about tax and debt burdens and threats to the competitiveness of the economy. They have clearly expressed a desire, indeed a demand, for all governments to follow more prudent fiscal policies, including better co-ordination of fiscal policies across jurisdictions and with monetary policy. Current constitutional discussions present an important opportunity to address this issue. Improved fiscal policy co-ordination has been at the forefront in many of the contributions that have emerged in the constitutional discussions.

More effective co-ordination will require a willingness on the part of all governments to work together for the good of all Canadians and effective mechanisms to translate this spirit into practice. As well as more collaborative efforts among governments, more effective co-ordination will require greater openness of the budget process.

Discussion of the state of the economy and near-term prospects across the country must form an important input to deliberations on joint fiscal policy strategies. As economic conditions may vary across the country, the appropriate fiscal course of action may not be the same for all jurisdictions. The co-ordination of fiscal policies does not necessarily imply identical stances across the country at a particular time.

In operational terms, more effective mechanisms to co-ordinate fiscal policies require:

- developing greater understanding of longer-term economic objectives and the role fiscal policies can play in support;

- jointly discussing the state of the economy and near-term prospects, at the national and provincial levels, and jointly addressing appropriate aggregate fiscal policy stances; and
- developing an annual budget cycle that facilitates the implementation of joint fiscal policy strategies by governments.

### *(d) How to Implement Better Policy Co-ordination*

*Proposals*

*The Government of Canada, therefore, proposes to develop with the provinces an annual timetable to allow for more open and visible federal and provincial budget-making processes that would include:*

- *a relatively fixed annual budget cycle;*
- *a fixed annual schedule of Finance Ministers' meetings;*
- *the publication by the 11 governments of pre-budget economic/fiscal outlooks; and*
- *common accounting conventions.*

*The Government of Canada proposes to develop, with the provinces, guidelines to improve the co-ordination of fiscal policies and the harmonization of fiscal policies with Canada's monetary policy. Once developed, the guidelines would be set in federal legislation under the new economic union power. Accordingly, these guidelines would require the approval of at least seven of the provinces representing 50 per cent of the population, and up to three provinces could opt out.*

Modifications are needed to the timing and nature of the budget processes of all governments. A fixed schedule for the delivery of budgets is quite important. Progress on this has been made in recent years and should be formalized further. There should also be a fairly fixed schedule for meetings of federal and provincial Finance Ministers. Fall and spring meetings should be regularized to facilitate more co-ordinated development of federal and provincial budgets in the context of a joint view of the economic outlook, and economic and fiscal pressures and objectives. The pre-budget meeting in the fall would become part of the budget deliberations of all governments; a post-budget meeting would compare objectives with budget results, and begin mapping out approaches to future challenges.

A regular part of these federal-provincial Finance Ministers' meetings should include sessions with the Governor of the Bank of Canada to address the interrelationships between fiscal policy stances and monetary conditions.

Greater openness of the budget processes of all governments is also needed. If the interdependence of fiscal policies is to be taken into account in the deliberations of each jurisdiction, the objectives, challenges and options facing each government must be much more readily apparent than at present. More open fiscal policy processes would also go a long way toward satisfying another central requirement for better co-ordination: greater transparency of policy and more opportunity for effective public input into budget deliberations. At present, Canadians often do not have a sufficient awareness of the objectives and intentions of governments, nor of the economic and fiscal pressures they face in dealing with their fiscal situations, until budgets are released.

As one element of the proposal for opening budget processes, all governments could simultaneously release pre-budget outlooks, through the vehicle of the federal-provincial Finance Ministers' meetings, indicating likely economic and fiscal outcomes on the basis of status quo policy stances. These statements could also outline where governments believe changes in

course may be required. This information would provide a focal point for useful public debate and input into budget decisions.

Such an opening of the budget process would have important implications for the established principles of budget secrecy. This issue has been reviewed in both a 1982 Government of Canada Green Paper and a 1985 Government of Canada Discussion Paper. The conventions of budget secrecy would still have to govern measures involving the possibility of unfair personal gain or unacceptable revenue losses. In practice, only a limited number of measures would be affected by this restriction. In sum, the budget processes could likely be opened considerably without impairing the fundamental needs of budget secrecy.

Active and effective public debate and understanding of fiscal policy issues would be substantially enhanced by regular and rigorous assessments of macroeconomic policy issues by an independent agency. In Canada such analyses have tended to be focused more on post-budget analyses than on pre-budget assessments, and have not developed the linkages among the fiscal policy options of the federal and the provincial governments and between the overall fiscal policy stance and monetary policy. Thus, relevant issues are not always brought to the forefront of public debate until after policy decisions have been taken. Canadians, consequently, often do not feel that they have input into budget deliberations and hence do not feel they are stakeholders in the decisions. There is need, and scope, for an independent agency to raise the profile of the public debate on macroeconomic policies in Canada. As discussed in section 3.4 below, such an agency would publish reviews of the fiscal policies of all governments, offer policy assessments and advice through federal-provincial Finance Ministers' meetings, and so raise public awareness of macroeconomic co-ordination issues.

These proposed changes are intended to improve fiscal policy processes, with the expectation that better processes will lead to better policy outcomes. This will particularly be the case if governments can exploit the advantages of improved co-ordination processes to develop a common viewpoint on basic guidelines for the conduct of responsible fiscal policies.

To assist the development of such a viewpoint, the federal government proposes to table for discussion by federal-provincial Finance Ministers possible guidelines for the conduct of fiscal policy in a medium-to-longer term context.

An example of such guidelines might be that budgets be balanced over the full course of the business cycle. Alternatively, in recognition of the validity of borrowing to finance expansion of the public capital stock where this will lead to higher rates of growth and living standards, the concept of a balanced budget over a business cycle could focus on the current services budget (total revenues and all expenditures excluding capital formation). In practice, guidelines such as these, to become operational, would require the development of common accounting systems and conventions. This would also help to increase transparency and accountability.

This section has proposed important modifications to fiscal policy processes, including the timing of various steps in budget deliberations. How this process of co-ordination might work in practice in a typical year is shown in the box on the next page.

### *Illustrative Annual Budget Cycle*

| | |
|---|---|
| Late October | First of fixed cycle of federal-provincial Finance Ministers' meetings; focus on status quo economic and fiscal outlooks, and options for addressing identified problems. The status quo federal and provincial economic and fiscal outlooks would be publicly released following the meeting.<br><br>The Governor of the Bank of Canada would present his views on the evolution of the economy and on the appropriate setting of macroeconomic policies, through testimony to a House of Commons Committee and by meeting with the Finance Ministers. |
| November-December | Public discussion of the joint federal-provincial "status quo" document. This discussion would be joined by a pre-budget status quo public report by the independent monitoring agency.<br><br>A process would be needed for this discussion of the pre-budget releases; the format and forum should attempt to move beyond constituency interests to a greater understanding of the tradeoffs involved in setting policy and perhaps greater consensus on the desired policy course. This could involve the Finance Committees of the various legislatures and federal Parliament. |
| January | Second of a fixed cycle of meetings; Ministers of Finance meet to review the fiscal options. The head of the independent monitoring agency would meet with the Ministers. |
| February-March | Federal Budget |
| March-April | Provincial Budgets |
| May-June | Third of a fixed cycle of meetings; regular federal-provincial Finance Ministers' meeting at the end of the budget cycle, to check direction of economy, discuss policy issues and prepare for next year's budget cycle.<br><br>The independent monitoring agency prepares an assessment of each government's budget and presents it to Finance Ministers. The monitoring agency's review of budgetary policies and their harmonization with monetary policy would subsequently be released. |

## 3.3 Monetary Policy in a Strengthened Economic Union

*Proposals*

*...the Government of Canada proposes to amend the Bank of Canada Act to make it clear that the mandate of the Bank is to achieve and preserve price stability. To ensure regional representation on the Board of Directors of the Bank of Canada, the Government will solicit the views of provincial and territorial governments and consult with them before making appointments to the Board. In addition, the Government proposes to create regional consultative panels to advise the Directors of the Bank on regional economic conditions. The Government will also solicit the views of provincial and territorial governments with respect to the membership of the regional panels. Moreover, as discussed above, the appointment of the Governor of the Bank of Canada would be subject to Senate ratification.*

### *(a) Context*

Monetary union has been a key source of the benefits of Canadian federalism. The use of a single currency has fostered the relatively free flow of people, goods, services and capital within and across the various regions.

For monetary policy to operate efficiently, and to maximize its contribution to the economic union, it is necessary that the mandate of the Bank of Canada be appropriate and clear. It is also necessary that monetary policy and fiscal policy be harmonized.

The essential underpinning of the widespread use of the Canadian dollar is trust and general confidence that it will not lose its value. The best contribution Canadian monetary policy can make to the well-functioning of the economic union, and the well-being of all Canadians, is to preserve the purchasing power of Canadian money.

There is considerable confusion about the objectives of monetary policy. Monetary policy has not been as transparent as it might have been and may not be sufficiently well understood across the country. Changes in interest rates are occasionally interpreted as changes in the objectives of monetary policy. In many parts of the country, there is the misperception that Canadian monetary policy is essentially a policy designed for Central Canada and does not give due consideration to the varying needs and circumstances of the regions. There is also an incorrect belief that the Bank of Canada could single-handedly, if it wanted to do so, lower all interest rates or even have different interest rates in different regions.

The most important function of the Bank of Canada, and certainly the most visible to all Canadians, is the implementation of monetary policy. Changes in the pace of monetary growth to achieve a desired monetary policy objective, with resulting effects on interest rates, leave no segment of Canadian society untouched. But monetary policy itself operates under constraints. In an economic union, monetary policy can only be Canada-wide in scope. The scope for lowering Canadian interest rates is constrained by inflation expectations and the confidence of international financial markets. It is also affected by the stance of other macroeconomic policies.

Over the last few years, the federal government and the Bank of Canada have emphasized the importance of directing monetary policy at containing and reducing inflation, and moving gradually and steadily to price stability. This is the only way to secure lower interest rates, support strong, sustainable growth, and avoid the distortions inflation causes in the distribution of income —

in particular the erosion of the real living standards of those on fixed incomes. The joint announcement by the federal government and the Bank of Canada of inflation targets at the time of the February 1991 Budget defined a clear path toward price stability.

The misperception of some that monetary policy is somehow a policy designed for Central Canada has been heightened by the example (cited in section 3.1 above) of the lack of co-ordination between Ontario fiscal policy and national monetary policy in the latter years of the 1980s. As Ontario accounts for more than 40 per cent of total output in Canada, economic conditions in that province will naturally have an important bearing on monetary conditions. However, when fiscal and monetary policy are straining against each other, the influence can be very counter-productive. The expansionary fiscal policy in Ontario in the late 1980s, stemming from rapid spending growth, was a direct source of the inflationary pressures monetary policy was required to quell. Interest rates had to rise much higher than would have been the case with more harmonious fiscal policies. The bluntness of monetary policy instruments, and the fact that their impact can be felt unequally across regions and sectors of the economy, have contributed to the rise in numerous misperceptions about monetary policy.

These misperceptions about what monetary policy can and cannot do need to be addressed. In short, they point both to the need to make monetary policy more open and understandable and to improve the harmonization of fiscal policies with monetary policy to maximize for all Canadians the benefits of achieving price stability. This can be accomplished through changes to clarify the Bank's mandate, through increased transparency of monetary policy, and through better ways of communicating monetary policy objectives and performance.

Clarifying the Bank's mandate and formalizing and strengthening communications channels would help to eliminate some of the misperceptions. These changes would also help to facilitate the harmonization of fiscal policies and monetary policy, and to ensure that they support each other and do not work at cross purposes. And a clearer mandate would be consistent with the independence of the implementation of monetary policy on an ongoing basis. At the same time, stronger regional assessment of the economic situation to the Bank's Board of Directors would enhance the authority of the Bank. The government's proposals in this area are set out in the following sections.

### *(b) Clarifying the Bank of Canada Mandate*

The only contribution the Bank of Canada can make to the well-being of all Canadians in the long run is to pursue policies which maintain the purchasing power of the nation's money. Preserving the purchasing power of Canadians over time should be the clear objective of monetary policy.

The *Bank of Canada Act* currently states that the Bank's mandate is:

> *...to regulate credit and currency in the best interest of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices, and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of Canada.*

The Bank of Canada's mandate should be clarified. A revised *Bank of Canada Act* should state that, in formulating and implementing monetary policy, the Bank of Canada is to guide the pace of monetary expansion and influence monetary and credit conditions with the objective of achieving and preserving stability in the general level of prices in Canada. The references to mitigating fluctuations in production, trade and employment and other objectives should be eliminated as they represent objectives either that history has taught us a central bank cannot achieve or that can only be achieved through price stability. A specific and clear mandate, unfettered by subordinated or competing objectives, will help to clarify some of the misunderstandings about what monetary policy can and cannot do in the longer term.

It will take time to achieve price stability in Canada, and the speed by which it is achieved will be important in shaping economic activity. As well, there will on occasion be economic shocks, often international in origin, that result in a temporary deviation from either the inflation targets or price stability. In determining the desired path toward price stability, and the appropriate pace to return to price stability following such shocks, monetary policy should be conducted with due cognizance of the path to price stability that best contributes to other Canadian economic objectives. While it is not appropriate to enshrine a specific path in the *Bank of Canada Act* , the Act should provide for a mechanism whereby the Bank of Canada and the government agree on, and make public, the desired path toward price stability. At the time of the February 1991 budget, the federal government and the Bank of Canada set out inflation targets for the 1991 to 1995 period as part of the process of moving toward price stability.

### *(c) Improving the Transparency of Monetary Policy*

For monetary policy to be transparent, there must be clear communication of its objectives and practices. At present, this communication is effected through channels such as the Governor's Annual Report to the Minister of Finance, the public release of the minutes of Bank of Canada Board meetings, the Governor's ad hoc appearances before parliamentary committees and his public speeches. These channels should be strengthened and extended in a number of ways in the interest of improving general understanding of monetary policy issues and the harmonization of fiscal policies with monetary policy.

The Governor appears occasionally before Parliament, mostly at the request of the chairman of the House of Commons Standing Committee on Finance. At present, there is no requirement in the *Bank of Canada Act* for him to do so on a regular basis. As part of the process of improving the transparency of monetary policy, the Governor of the Bank should be required to testify regularly before Parliament on past financial and economic developments and likely future developments, and on the intended course of monetary policy over the upcoming year. Regular semi-annual appearances should be considered — first in the fall when federal and provincial budgets are being prepared and, second, around the time of the Governor's Annual Report, which is usually published in March.

As part of the fiscal co-ordination process, the Governor should also be mandated to meet with the federal-provincial Ministers of Finance to present his views about the state of the economy and discuss interactions of monetary policy with fiscal policies.

Directors have traditionally been selected from the regions of Canada, and this tradition will continue. Directors would be nominated by the federal government after consultation with provincial governments. The appointment of the Governor would be ratified by the Senate.

Directors of the Bank of Canada should be given a greater public role. To keep abreast of regional economic issues, and to improve communications on monetary policy issues, they would chair new regional consultative panels. The government will solicit views of provincial and territorial governments with respect to membership of the regional panels. These panels would be convened to review the regional and provincial economic situations; the reports from these meetings of the regional consultative panels would be published as part of the minutes of the meetings of the Bank of Canada's Board of Directors.

## 3.4 A Role for an Independent Monitoring Agency in Enhancing Macroeconomic Policy Co-ordination

*Proposals*

*The Government of Canada also proposes to discuss with the provinces the establishment of an independent agency to monitor and evaluate the macroeconomic policies of the federal and provincial governments.*

A number of countries have developed institutions to foster better intergovernmental co-ordination of macroeconomic policies. For example, in Germany, the central government and the *Länder* are required by law to co-operate and co-ordinate their fiscal policies to ensure that the overall stance of fiscal policy is appropriate given underlying economic conditions. In addition, an independent council provides regular advice to both levels of government and in general raises the public awareness and understanding of policy issues. On the international front, all member OECD countries are subject to a regular public review of their economic policies while members of the International Monetary Fund and the European Commission undergo regular internal policy reviews.

Canada lacks such a focused institution to aid the macroeconomic policy co-ordination process. This reduces the capacity for public understanding of, and input into, macroeconomic policy deliberations by governments in Canada. As well, there is less public pressure on the policy-makers to co-ordinate their actions because policy measures come under less frequent and less rigorous scrutiny by the public than should be the case.

To nurture the process of fiscal policy co-ordination, the government proposes to create, in co-operation with the provinces, a new independent monitoring agency with a mandate to focus exclusively on the setting of macroeconomic policies by the federal and provincial governments. The primary objective of this agency would be to report regularly on Canadian macroeconomic policies and to act as a public interpreter on how well year-to-year policies mesh with longer-term macroeconomic objectives.

In the context of the clearly stated longer-term macroeconomic objectives of price stability and fiscal responsibility, the agency's principal focus would be:

- the near-term setting of Canadian macroeconomic policies;
- the soundness of the fiscal policies pursued by the federal and provincial governments;
- the consistency of fiscal and monetary policies; and
- macroeconomic prospects, tensions and imbalances which are likely to arise under inappropriate policies.

Reports of the monitoring agency, to the federal and provincial Ministers of Finance and to the public, would form an essential part of the overall fiscal co-ordination process. This monitoring agency would meet semi-annually with federal-provincial Finance Ministers as part of the process of enhanced policy co-ordination. It could also testify annually before the House Finance Committee and each provincial Finance Committee. It would also conduct, and publish each year, reviews of each government's macroeconomic policies along the lines of the OECD surveys.

It is proposed that such an agency would be established and financed jointly by the federal and provincial governments. As its mission would be highly specialized, its staff would consist of a small number of experts and some administrative support.

*Illustrative Role of the Monitoring Agency*

| | |
|---|---|
| Late October | Status quo economic and fiscal outlook to complement outlooks produced by the various governments. |
| November-December | The agency submits to the Ministers of Finance and the public a report reviewing likely macroeconomic tensions and imbalances in the near future and, in this light, advises on the desirable stance of macroeconomic policies in light of the state of the economy and fiscal guidelines.<br><br>Ministers would use this report in formulating fiscal policies (size of the deficits, levels of expenditures and taxes, etc.) to be followed by governments in the near term. |
| May-June | The monitoring agency would prepare an assessment of the budgets of each government. A key element would be an evaluation of these policies and a determination of whether they were compatible with agreed objectives and guidelines. |

# Annex

## Examples of Impediments to the Free Flow of People, Goods, Services and Capital

### *(i) Government Procurement*

Preferential government procurement practices represent a barrier to internal trade in both goods and services. They are perhaps the largest single source of costs arising from internal barriers.

The scope of preferential government procurement can be quite wide. For example, a firm incorporated in one province often cannot bid on a government contract in another province, even though it may be capable of doing the job at lower cost. Further, firms that do win public contracts in other provinces can be required to set up new production facilities in that province, adding costs and reducing efficiency. These restrictions can apply to both contractors and subcontractors on public contracts. Contractors can be forced to substitute higher-cost, locally supplied, materials and equipment for lower-cost supplies from another province.

Several approaches have been taken to implement preferential procurement policies. One common approach has been to use a price preference. For example, B.C. has provided a preference of 10 per cent to provincially manufactured goods on contracts under $200,000. Manitoba, New Brunswick, Newfoundland, and Prince Edward Island have provided for similar preferences. Even where an out-of-province supplier is chosen, there may be a policy supporting use of local labour and services. For example, Saskatchewan has had such a policy in respect of major projects. There may also be attempts to gain "offsets", with out-of-province suppliers agreeing to purchase supplies or services in the province.

While the policy intent of such requirements is to support local business and employment, the effect is clearly to raise the cost of government purchases with a direct cost to taxpayers. In some cases, it also inhibits the growth of larger, more specialized firms, with resulting costs for the national economy. When the policies are in place in all provinces, apparent benefits to a given provincial economy may be cancelled out by policies pursued elsewhere, and net new costs for the economy as a whole will be the principal result.

Governments have recognized the cost of such procurement practices on a regional basis. The Maritime provinces have reached an agreement in principle on replacing provincial preferences with a regional one. The Western provinces have taken a similar approach. There has also been substantial progress on an intergovernmental agreement on procurement of goods which would include both federal and provincial governments. However, the agreement would not extend to such activities as construction, provision of services and the procurement of goods by local governments or Crown corporations. Further progress on the reduction or

elimination of such barriers in the internal market would be an important contributor to improved national economic performance.

### (ii) Wire and Cable Manufacturing

Most electrical and some telephone utilities in Canada are provincial Crown corporations. Historically, these corporations, through the direction of their respective governments, have attempted to support the development of local industrial capacity. This has involved the implementation of preferential purchasing practices whereby suppliers of wire and cable that meet provincial content requirements have received favourable treatment in the awarding of contracts.

Provincial governments have justified these preferential policies through reference to a number of key objectives including: creating local employment opportunities; developing local windows on technology in the sector; providing facilities for product testing under local conditions; and creating a secure local supply source and readily accessible source of inventories.

On a national basis, however, these discriminatory policies have encouraged significant fragmentation in the wire and cable industry as major manufacturers have had to establish a system of small plants to qualify for the preferential treatment. Between them, the five largest manufacturers operate 31 plants across Canada. Approximately one third of the plants in the industry have fewer than 50 employees. Although accounting for one third of establishments, these plants provide only 4 per cent of total shipments in the industry. Plants with fewer than 50 employees produce only two thirds of the output per employee of medium-size establishments (with 50 to 199 employees).

Clearly, while preferential procurement practices of public utilities may have helped achieve some important public policy goals, they have also contributed to the creation of an industrial structure for wire and cable manufacture in Canada that is marred by small-scale, less-efficient plants, resulting in higher costs for Canadian businesses and consumers.

In an increasingly open international trading environment, these costs will become more difficult to sustain. Under the Canada-U.S. Free Trade Agreement, for example, the reduction of duties will place these small plants under strong competitive pressure. The continuation of preferential purchasing policies could lead to even greater cost differentials than at present, further raising costs to Canadian businesses and consumers.

The elimination of these barriers could be an important factor in promoting the creation of a lower-cost industrial structure that would reduce prices for Canadian businesses and consumers, and strengthen the industry's competitive position vis-à-vis international rivals who face fewer impediments in their internal markets.

### (iii) Beer Marketing

In Canada, provincial liquor boards are granted monopolies over the distribution of beer, including its importation into, and marketing within, the province. These monopolies have led to practices by liquor boards that range from absolute prohibition of beer imports from other provinces to varying degrees of listing, pricing and distribution policies that impede the interprovincial flow of beer. Some of these practices have been eliminated, and it is expected that further progress will be made in this area through the Intergovernmental Agreement on Beer Marketing Practices, which entered into force on January 1, 1991, for Alberta, British Columbia, Ontario, Prince Edward Island,

Quebec and Saskatchewan. The Agreement will eliminate discriminatory listing and pricing policies and practices among participating provinces. However, it does not lay down a direct obligation to eliminate discrimination in the distribution of out-of-province beer.

The provinces have exercised their monopolies to ensure the presence of the brewery industry and associated jobs in their provinces. As a result, breweries operate 67 plants in nine different provinces. Given the nature of the technology in the industry, they could supply the entire country with far fewer plants.

While provincial practices have supported local jobs in the industry, these have come at a significant cost to consumers, who have not had access to the full range of products and who have been required to pay more for the product than if production had been rationalized. The oft-heard example of the "costs" is that of an Ontarian having to cross the border into the United States in order to buy Moosehead, a beer that is produced only in Canada, but has limited national distribution.

These costs are obviously small. More significantly, the entire structure of the industry may now be at risk as a result of international pressures that may expedite a very disruptive rationalization of the industry. Certain practices of provincial liquor boards were reviewed in a GATT panel report of 1988, following a complaint by the European Community. The panel ruled against provincial practices. A more recent complaint by the United States specifically dealing with the marketing of beer at the provincial level is currently before a GATT panel. The outcome may be that provinces will no longer be able to have separate distribution schemes for foreign and provincially produced beer. Large foreign breweries able to produce at low cost and export into Canada would, for the first time, be able to compete more openly with the fragmented domestic industry. Canadian plants, designed to service only a small provincial market, have higher production costs and may not be able to compete. The only way for the Canadian industry to compete effectively in this climate, and to preserve jobs in the long term, is if interprovincial barriers to trade are removed, so that the industry could rationalize and achieve production efficiencies.

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